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RUEHBO/AMEMBASSY BOGOTA 3754
RUEHQT/AMEMBASSY QUITO 1826
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E.O. DECL:05/25/2016
TAGS: EFIN ECON PGOV PREL BR
SUBJECT: BRAZIL - SPECULATION ABOUT SPECULATIVE CURRENCY ATTACK

REF: A) BRASILIA 1008   B) BRASILIA 0961

Classified by Economic Counselor Bruce Williamson, reasons 1.4 (b) and (d).

¶1. (U) Local financial press reported on May 25 that the Real's 4.5% depreciation of the previous day had been the product of a speculative attack by foreign hedge funds. According to leading financial daily Valor Economico and influential economic journalist Miriam Leitao, foreign hedge funds that were trying to sell inflation-indexed real-denominated GoB bonds (maturing in 2035) discovered that, due to the current financial market volatility and emerging market risk reassessment, the secondary market for the long bond had completely dried up. According to these reports, the funds then led a speculative attack on the Real until the GoB stepped in to calm the markets by re-purchasing its long bonds. In another setback, after finding no market for its fixed-rate longer term domestic debt, the GoB was compelled to issue shorter term variable-rate bonds indexed to the overnight benchmark rate (SELIC) in order to meet its financing requirements.

¶2. (C) JP Morgan Brazil President Charles Wortman and CSFB Chief Economist Nilson Teixeira told Econoff May 25 that they were puzzled by the media's characterization of the events of May 24, which they did not believe amounted to a speculative attack. Wortman, many of whose clients have been steadily moving out of Real-denominated assets over the course of the last week, said that there did not appear to have been a coordinated action against the currency. He argued that it made little sense for the hedge funds, if their motivation was displeasure over their inability to unload GoB Real-denominated bonds, to attack the currency as this would further undermine the value of their assets. Moreover, he noted, most of the depreciation had taken place late in the trading session, when a lack of liquidity meant smaller transactions could have larger effects on the price. Separately, Teixeira stated that he did not believe the

depreciation of May 24 had been caused by a speculative attack.

¶3. (C) Both Wortman and Teixeira stated that Brazil's fundamentals remained solid. Teixeira said these fundamentals would reassert themselves after world financial markets adjusted to new risk perceptions and reached a new equilibrium. Wortman elaborated on this point: Brazil's private sector was much less indebted now than during the 1998/99 Russia financial crisis or the 2002 crisis of confidence over Lula's likely election. The country's foreign currency debt, moreover, has declined and its tenor has increased. The public sector has no net foreign currency exposure right now, he added, given its US$63 billion in reserves, reduced external debt and elimination of dollar-linked domestic debt.

¶4. (C) Despite the volatility and high net dollar outflows in the seven days leading up to May 24, Wortman stated that JP Morgan is still seeing investor interest in Brazil remain strong. The company had just sponsored a group of investors on a two-week visit to Brazil that happened to coincide with the outbreak of market volatility. These investors, according to Wortman, remained very interested in Real assets despite the episode and were planning to invest. Wortman interpreted this to mean that, despite the global asset reallocation that major institutional players were undertaking, Brazil remained a good bet. He further noted that market volatility in Brazil tends to be higher in environments like this one in part because it is a more liquid market than most emerging economies. This means institutions that are reducing their exposure to the emerging market asset class find it easier to move out of Brazilian assets than those of other countries. The volatility, therefore, is not necessarily a good guide to the market's

perceptions of Brazil's fundamentals, Wortman argued.

¶5. (C) Comment: Financial market actors here seem to be fairly confident that Brazil's solid economic fundamentals should reassert themselves once the international markets have re-balanced. If overly prolonged, however, the current market uncertainty could begin to undermine some of the GoB's recent achievements, including its move away from issuance of variable rate domestic debt linked to the SELIC, which it was replacing with fixed rate and inflation-indexed long-term domestic debt. (Note: the GoB does have a large cash reserve to cover upcoming debt repayment obligations, but would prefer not to draw on it.) If continued, the market volatility may also slow, or perhaps even interrupt, the Central Bank's current cycle of monetary loosening. But as Finance Minister Mantega's barely-concealed glee during a May 25 interview made clear, there are many here, particularly among exporters, who welcome the devaluation and dearly would love to see the Real continue to weaken.

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